

## Internal Revenue Service, Treasury

## § 53.4940-1

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### Subpart A—Taxes on Investment Income

#### § 53.4940-1 Excise tax on net investment income.

(a) *In general.* For taxable years beginning after September 30, 1977, section 4940 imposes an excise tax of 2 percent of the net investment income (as defined in section 4940(c) and paragraph (c) of this section) of a tax-exempt private foundation (as defined in section 509). For taxable years beginning after December 31, 1969, and before October 1, 1977, the tax imposed by section 4940 is 4 percent of the net investment income. This tax will be reported on the form the foundation is required to file under section 6033 for the taxable year and will be paid annually at the time prescribed for filing such annual return (determined without regard to any extension of time for filing). In addition, an excise tax is imposed in the manner prescribed in paragraph (b) of this section on certain non-exempt private foundations (including certain non-exempt charitable trusts). Except as provided in the succeeding sentence, this tax is to be reported by means of a schedule attached to the organization's income tax return. For taxable years ending on or after December 31, 1975,

the tax imposed by section 4940(b) and paragraph (b) of this section on a trust described in section 4947(a)(1) which is a private foundation shall be reported on Form 5227. The tax imposed by section 4940(b) and this section is to be paid annually at the time the organization is required to pay its income taxes imposed under subtitle A. Except as otherwise provided herein, no exclusions or deductions from gross investment income or credits against tax are allowable under this section.

(b) *Taxable foundations.* (1) The excise tax imposed under section 4940 on private foundations which are not exempt from taxation under section 501(a) is equal to:

(i) The amount (if any) by which the sum of

(A) The tax on net investment income imposed under section 4940(a), computed as if such private foundation were exempt from taxation under section 501(a) and described in section 501(c)(3) for the taxable year, plus

(B) The amount of the tax which would have been imposed under section 511 for such taxable year if such private foundation had been exempt from taxation under section 501(a), exceeds.

(ii) The tax imposed under subtitle A on such private foundation for the taxable year.

(2) The provisions of this paragraph may be illustrated by the following examples:

*Example (1).* Assume that the tax liability under subtitle A for private foundation X, which is not exempt from taxation under section 501(a) for 1970, is \$10,000. Had X been exempt under section 501(a) for 1970, the tax imposed under section 4940(a) would have been \$4,000 and the tax imposed under section 511 would have been \$7,000. The excess of the sum of the taxes which would have been imposed under sections 4940(a) and 511 (\$11,000) over the tax that was imposed under subtitle A (\$10,000) is \$1,000, the amount of the tax imposed on such organization under section 4940(b).

*Example (2).* Assume the facts stated in Example (1), except that the tax liability under subtitle A is \$15,000 rather than \$10,000. Because the sum of the taxes which would have been imposed under sections 4940(a) and 511 (\$11,000) does not exceed the tax that was imposed under subtitle A (\$15,000), there is no tax imposed under section 4940(b) with respect to such foundation.

(c) *Net investment income defined*—(1) *In general.* For purposes of section 4940(a), *net investment income* of a private foundation is the amount by which:

(i) The sum of the gross investment income (as defined in section 4940(c)(2) and paragraph (d) of this section) and the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (within the meaning of section 4940(c)(4) and paragraph (f) of this section) exceeds

(ii) The deductions allowed by section 4940(c)(3) and paragraph (e) of this section.

Except to the extent inconsistent with the provisions of this section, net investment income shall be determined under the principles of Subtitle A.

(2) *Tax-exempt income.* For purposes of computing net investment income under section 4940, the provisions of section 103 (relating to interest on certain governmental obligations) and section 265 (relating to expenses and interest relating to tax-exempt income) and the regulations thereunder shall apply.

(d) *Gross investment income*—(1) *In general.* For purposes of paragraph (c) of this section, “gross investment income” means the gross amounts of income from interest, dividends, rents, and royalties (including overriding royalties) received by a private foundation from all sources, but does not include such income to the extent included in computing the tax imposed by section 511. Under this definition, interest, dividends, rents, and royalties derived from assets devoted to charitable activities are includible in gross investment income. Therefore, for example, interest received on a student loan would be includible in the gross investment income of a private foundation making such loan. For purposes of paragraph (c) of this section, gross investment income also includes the items of investment income described in § 1.512(b)-1(a).

(2) *Certain estate and trust disbursements.* In the case of a distribution from an estate or a trust described in section 4947(a) (1) or (2), such distribution shall not retain its character in

the hands of the distributee for purposes of computing the tax under section 4940; except that, in the case of a distribution from a trust described in section 4947(a)(2), the income of such trust attributable to transfers in trust after May 26, 1969, shall retain its character in the hands of a distributee private foundation for purposes of section 4940 (unless such income is taken into account because of the application of section 671).

(3) *Treatment of certain distributions in redemption of stock.* For purposes of applying section 302(b)(1), any distribution made to a private foundation by a disqualified person (as defined in section 4946(a)), in redemption of stock held by such private foundation in a business enterprise shall be treated as not essentially equivalent to a dividend if all of the following conditions are satisfied: (i) Such redemption is of stock which was owned by a private foundation on May 26, 1969 (or which is acquired by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date, which is in effect on such date and at all times thereafter, or would have passed under such a will but before that time actually passes under a trust which would have met the test of this subdivision but for the fact that the trust was revocable (but was not in fact revoked)); (ii) such foundation is required to dispose of such property in order not to be liable for tax under section 4943 (relating to taxes on excess business holdings); and (iii) such foundation receives in return an amount which equals or exceeds the fair market value of such property at the time of such disposition or at the time a contract for such disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law). In the case of a disposition before January 1, 1975, section 4943 shall be applied without taking section 4943(c) (4) into account. A distribution which otherwise qualifies under section 302 as a distribution in part or full payment in exchange for stock shall not be treated as essentially equivalent to a dividend

because it does not meet the requirements of this subparagraph.

(e) *Deductions—(1) In general.* (i) For purposes of computing net investment income, there shall be allowed as a deduction from gross investment income all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income, determined with the modifications set forth in subparagraph (2) of this paragraph. Such expenses include that portion of a private foundation's operating expenses which is paid or incurred for the production or collection of gross investment income. Taxes paid or incurred under this section are not paid or incurred for the production or collection of gross investment income. A private foundation's operating expenses include compensation of officers, other salaries and wages of employees, outside professional fees, interest, and rent and taxes upon property used in the foundation's operations. Where a private foundation's officers or employees engage in activities on behalf of the foundation for both investment purposes and for exempt purposes, compensation and salaries paid to such officers or employees must be allocated between the investment activities and the exempt activities. To the extent a private foundation's expenses are taken into account in computing the tax imposed by section 511, they shall not be deductible for purposes of computing the tax imposed by section 4940.

(ii) Where only a portion of property produces, or is held for the production of, income subject to the section 4940 excise tax, and the remainder of the property is used for exempt purposes, the deductions allowed by section 4940(c)(3) shall be apportioned between the exempt and non-exempt uses.

(iii) No amount is allowable as a deduction under this section to the extent it is paid or incurred for purposes other than those described in subdivision (i) of this subparagraph. Thus, for example, the deductions prescribed by the following sections are not allowable: (1) The charitable deduction prescribed under section 170 and 642(c); (2)

the net operating loss deduction prescribed under section 172; and (3) the special deductions prescribed under Part VIII, Subchapter B, Chapter 1.

(2) *Deduction modifications.* The following modifications shall be made in determining deductions otherwise allowable under this paragraph:

(i) The depreciation deduction shall be allowed, but only on the basis of the straight line method provided in section 167(b)(1).

(ii) The depletion deduction shall be allowed, but such deduction shall be determined without regard to section 613, relating to percentage depletion.

(iii) The basis to be used for purposes of the deduction allowed for depreciation or depletion shall be the basis determined under the rules of Part II of Subchapter O of Chapter 1, subject to the provisions of section 4940(c)(3)(B), and without regard to section 4940(c)(4)(B), relating to the basis for determining gain, or section 362(c). Thus, a private foundation must reduce the cost or other substituted or transferred basis by an amount equal to the straight line depreciation or cost depletion, without regard to whether the foundation deducted such depreciation or depletion during the period prior to its first taxable year beginning after December 31, 1969. However, where a private foundation has previously taken depreciation or depletion deductions in excess of the amount which would have been taken had the straight line or cost method been employed, such excess depreciation or depletion also shall be taken into account to reduce basis. If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to a donee private foundation, then the original basis to such foundation of such property shall be determined under the rules of § 1.1015-1(a)(3).

(iv) The deduction for expenses paid or incurred in any taxable year for the production of gross investment income earned as an incident to a charitable function shall be no greater than the income earned from such function which is includible as gross investment income for such year. For example, where rental income is incidentally re-

alized in 1971 from historic buildings held open to the public, deductions for amounts paid or incurred in 1971 for the production of such income shall be limited to the amount of rental income includible as gross investment income for 1971.

(f) *Capital gain and losses*—(1) *General rule.* In determining capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for purposes of the tax imposed by section 4940, there shall be taken into account only capital gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program-related investments, as defined in section 4944(c)), and property used for the production of income included in computing the tax imposed by section 511 except to the extent gain or loss from the sale or other disposition of such property is taken into account for purposes of such tax. For taxable years beginning after December 31, 1972, property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interests, mortgages, and securities). Under this subparagraph, gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded. For example, gain or loss on the sale of the buildings used for the exempt activities of a private foundation would not be subject to the section 4940 tax. Where the foundation uses property for its exempt purposes, but also incidentally derives income from such property which is subject to the tax imposed by section 4940(a), any gain or loss resulting from the sale or other disposition of such property is not subject to the tax imposed by section 4940(a). For example, if a tax-exempt private foundation maintains buildings of a historical nature and keeps them open for public inspection, but requires a number of its employees to live in these buildings and charges the employees rent, the rent would be

subject to the tax imposed by section 4940(a), but any gain or loss resulting from the sale of such property would not be subject to such tax. However, where the foundation uses property for both exempt purposes and (other than incidentally) for investment purposes (for example, a building in which the foundation's charitable and investment activities are carried on), that portion of any gain or loss from the sale or other disposition of such property which is allocable to the investment use of such property must be taken into account in computing capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such taxable year. For purposes of this paragraph, a distribution of property for purposes described in section 170(c) (1) or (2)(B) which is a qualifying distribution under section 4942 shall not be treated as a sale or other disposition of property.

(2) *Basis.* (i) The basis for purposes of determining gain from the sale or other disposition of property shall be the greater of:

(A) Fair market value on December 31, 1969, plus or minus all adjustments after December 31, 1969, and before the date of disposition under the rules of Part II of Subchapter O of Chapter 1, provided that the property was held by the private foundation on December 31, 1969, and continuously thereafter to the date of disposition, or

(B) Basis as determined under the rules of Part II of Subchapter O of Chapter 1,

subject to the provisions of section 4940(c)(3)(B) (and without regard to section 362(c)).

(ii) For purposes of determining loss from the sale or other disposition of property, basis as determined in subdivision (i)(B) of this subparagraph shall apply.

(3) *Losses.* Where the sale or other disposition of property referred to in section 4940(c)(4)(A) results in a capital loss, such loss may be subtracted from capital gains from the sale or other disposition of other such property during the same taxable year, but only to the extent of such gains. Should losses from the sale or other disposition of such property exceed gains from the sale or other disposition of such prop-

erty during the same taxable year, such excess may not be deducted from gross investment income under section 4940(c)(3) in any taxable year, nor may such excess be used to reduce gains in either prior or future taxable years, regardless of whether the foundation is a corporation or a trust.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

*Example (1).* A private foundation holds certain depreciable real property on December 31, 1969, having a basis of \$102,000. The fair market value of such property on that date was \$100,000. For its taxable year 1970 the foundation was allowed depreciation for such property of \$5,100 on the straight line method, the allowable amount computed on the \$102,000 basis. The property was sold on January 1, 1971, for \$100,000. Because fair market value on December 31, 1969, less straight line depreciation of \$5,100 (\$96,900) is less than basis as determined by Part II of Subchapter O of Chapter 1, \$96,900 (\$102,000 less \$5,100), a gain of \$3,100 is recognized (i.e., sales price of \$100,000 less the greater of the two possible bases).

*Example (2).* Assume the same facts in example 1, except that the sale price was \$95,000. Because the sale price was \$1,900 less than the basis for loss (\$96,900 as determined by the application of subparagraph (2)(ii) of this paragraph), there is a capital loss of \$1,900 which may be deducted against capital gains for 1971 (if any) in determining net capital gain (capital gain net income for taxable years beginning after December 31, 1976).

*Example (3).* A private foundation holds certain depreciable real property on December 31, 1969, having a basis of \$102,000. The fair market value of such property on that date was \$110,000. For its taxable year 1970 the foundation was allowed depreciation for such property of \$5,100 on the straight line method, the allowable amount computed on the \$102,000 basis. The property was sold on January 1, 1971, for \$100,000. Fair market value on December 31, 1969, less straight line depreciation of \$5,100 (\$104,900) exceeds basis as determined by Part II of Subchapter O of Chapter 1, \$96,900 (\$102,000 less \$5,100), and will be used for purposes of determining gain. Because basis for purposes of determining gain exceeds sale price, there is no gain. There is no loss because basis for purposes of determining loss (\$96,900) is less than sale price.

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